

December 21, 2017

Marybel Batjer, Secretary
California Government Operations Agency
915 Capitol Mall, Suite 200
Sacramento, CA 95814

Dear Ms. Marybel Batjer,

In accordance with the State Leadership Accountability Act (SLAA), the California Department of Tax and Fee Administration submits this report on the review of our internal control and monitoring systems for the biennial period ending December 31, 2017.

Should you have any questions please contact Katie Hagen, Chief Deputy Director , at (916) 324-4490, Katie.Hagen@cdtfa.ca.gov.

BACKGROUND

The Taxpayer Transparency and Fairness Act of 2017, which took effect July 1, 2017, restructured the State Board of Equalization (BOE) and separated its functions among three separate entities to guarantee impartiality, equity, and efficiency in tax appeals, protect civil service employees, ensure fair tax collection statewide, and uphold the California Taxpayers' Bill of Rights. These include the BOE, the California Department of Tax and Fee Administration (CDTFA) and the Office of Tax Appeals.

CDTFA administers the state's sales and use tax, fuel, tobacco, cannabis and other taxes, and collects fees to fund and administrate 37 specific state tax and fee programs. More than 1.3 million California businesses are registered with the department to engage in retail sales in the state. In fiscal year 2015-16, these programs generated more than \$64 billion in tax revenue to support state and local government.

The mission of the CDTFA is to make life better for Californians by fairly and efficiently collecting the revenue that makes our public services possible.

CDTFA's primary goals include:

- Working smarter through the modernization of our processes and systems. We're building the nation's most effective 21st century revenue department. By streamlining our processes and harnessing new technologies, we will do our jobs more effectively and adapt to meet the challenges of the modern marketplace.
- Providing superior taxpayer service. Taxes can be complicated. To maximize voluntary compliance, we work with taxpayers to operate a system that is fair, accessible, understandable and transparent.
- Strengthening the department through a firm commitment to the success of our team. The department's success hinges on our ability to attract and retain the best workforce. To that end, we are committed to recognizing excellence, supporting our colleagues and providing team members the professional development necessary to succeed and grow.

ONGOING MONITORING

As the head of California Department of Tax and Fee Administration, Nicolas Maduros, Director, is responsible for the overall establishment and maintenance of the internal control and monitoring systems.

EXECUTIVE MONITORING SPONSOR(S)

The executive monitoring sponsor responsibilities include facilitating and verifying that the California Department of Tax and Fee Administration internal control monitoring practices are implemented and functioning as intended. The responsibilities as the executive monitoring sponsor(s) have been given to: Nicolas Maduros, Director, and Katie Hagen, Chief Deputy Director .

MONITORING ACTIVITIES

The California Department of Tax and Fee Administration (CDTFA) has several processes that involve assessing and monitoring risks.

First and foremost, management's leadership and commitment towards honesty, integrity and ethical behavior is a very important component of CDTFA's control environment and is taken very seriously.

Recently, CDTFA established an Enterprise Risk Management Committee (ERMC). The ERMC is made up of the Senior Staff team which comprises of the Director, Chief Deputy Director, Chief Counsel, Division Deputy Directors, and select Bureau Chiefs. The Director of CDTFA is the chair of the ERMC and the other members are a part of the governing body. The ERMC is taking a risk-based approach to managing the department's risks and integrating concepts of internal control and strategic planning.

To accomplish this, the ERMC will meet as frequently as required, and no less than once a month. When fulfilling the role of the ERMC, Senior Staff will be accountable for performing the duties and responsibilities set forth in the established ERMC Charter. A risk assessment tool, as well as division and enterprise-wide watch point lists, have been established to capture and monitor risks.

CDTFA's ERMC uses a risk management model that reflects ongoing risk management as a never ending circular process. Core elements in the risk management model include risk identification, risk assessment, risk response, and risk reporting. Throughout all components is the need for communication and learning across the organization. The model illustrates that the core risk management process cannot be isolated and must be an enterprise-wide approach.

CDTFA is adapting to the 'Three Lines of Defense' model, as outlined by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). This model allows the department to better establish and coordinate duties related to risk and control. The model proposes that the ERMC oversee and direct three lines of defense that contribute to effective management of risk and control. These three lines consist of the following:

1st line of defense—Operational Management has ownership, responsibility and accountability for directly assessing, controlling and mitigating risks;

2nd line of defense—Governance, ERMC, Information Technology and other control functions monitor and facilitate the implementation of effective risk management and assist the risk owners in reporting adequate risk related information up and down the department; and

3rd line of defense—Internal Audit, through a risk-based approach to its work, will provide assurance to the department's audit committee and Senior Staff. This assurance will cover how effectively the

organization assesses and manages its risks and will include assurance on the effectiveness of the 1st and 2nd lines of defense.

ADDRESSING VULNERABILITIES

Once risks are identified, they are logged into the ERM Risk Assessment Tool and risk owners are assigned. The risk owners will then utilize subject matter experts from across the department to develop a strategy and a plan to treat the risk. The plan identifies what controls are in place (if any) and what additional controls need to be put in place to reduce or control the risk. The ERM monitors the progress of the risk by following up with the risk owners and subject matter experts at their monthly ERM meetings. The plan also provides a target date for completion.

The ERM team will conduct an accurate and thorough assessment of the potential risks and vulnerabilities to the department. Addressing these identified vulnerabilities will include ensuring policies, procedures, standards and/or guidelines are effective. Measures will be taken to successfully reduce risks and vulnerabilities to a reasonable and appropriate level.

COMMUNICATION

Reporting of identified risks by the risk owners will be provided to Senior Staff at the monthly ERM meetings. Communication to all staff will be dependent upon Senior Staff sharing information at their staff meetings. Additionally, a SharePoint site is maintained for staff to access documents including ERM's Charter, the ERM Risk Assessment Tool, as well as other documents to assist in the identification, mitigation and monitoring practices of risks. Updates on risks will also be given by a Senior Staff representative at the semi-annual CDTFA managers' meeting as needed.

ERM plans to work with CDTFA's External Affairs Division to help incorporate and communicate risk awareness into the department's culture and ways of doing business.

ONGOING MONITORING COMPLIANCE

The California Department of Tax and Fee Administration is in the process of implementing and documenting the ongoing monitoring processes as outlined in the monitoring requirements of California Government Code sections 13400-13407. These processes include reviews, evaluations, and improvements to the California Department of Tax and Fee Administration systems of controls and monitoring.

RISK ASSESSMENT PROCESS

The following personnel were involved in the California Department of Tax and Fee Administration risk assessment process: Executive Management, Middle Management, and Front Line Management.

RISK IDENTIFICATION

The Internal Audit Bureau provided each division a risk reporting tool (Excel spreadsheet), instructions, prior 2015 SLAA report and the department's 2015-2020 Strategic Plan to assist in risk identification. The risk reporting tool captures the risks, potential consequences, and a risk ranking score based on the likelihood and impact of the risk occurring.

Each division completed the risk reporting tool by conducting meetings with their mid-level managers to identify the risks to their division. The various division risks were compiled into a single report for the entire department and presented to Senior Staff.

RISK RANKING

A risk assessment workshop was held for Senior Staff. At this workshop, risks from the 2015 SLAA report as well as the outcome of the department-wide risk reporting tool were discussed. After a lengthy discussion among Senior Staff, the risks were narrowed down to the enterprise-wide risks and then ranked. The ranking process was based on the risk level score which considered the likelihood and impact of the risk occurring. The top risks of the department were captured and submitted for the SLAA report.

RISKS AND CONTROLS

RISK: OPERATIONS -INTERNAL-STAFF—SAFETY

There is an increased risk to the public and to CDTFA staff performing compliance/collection and audit activities related to the cannabis industry.

With the transition from an illegal industry to that of a more mainstream industry, CDTFA can expect to encounter difficulties collecting tax revenue, increased risk of crime, and the challenge of the industry being able to effectively engage in banking and commerce. We anticipate increased interaction with this primarily cash-based industry.

The increased risk follows the California voters approving the legalization of recreational cannabis in California which will be effective January 1, 2018. While legal in California, the federal government still considers cannabis a Schedule 1 drug under the Controlled Substance Act.

As a result of this risk, CDTFA compliance and audit staff working in the field and in our field offices may be subject to more threats of physical harm and criminal mischief.

CONTROL A

The CDTFA will mitigate risk through a series of education and outreach efforts to those in the cannabis industry. The goal is to ensure the cannabis industry is aware of their obligations and to assist them in registering and understanding their reporting requirements in order to maximize voluntary compliance. With increased voluntary compliance comes less potential for conflict and reduces the risk to staff.

CONTROL B

The CDTFA will mitigate risk to staff and the public through improved procedures for handling in-person tax payments and enhanced safety and security measures in our field offices. These changes will allow CDTFA to process payments much faster and creates a safer and more secure environment when interacting with the public in our field offices.

RISK: OPERATIONS -INTERNAL-TECHNOLOGY—DATA SECURITY

The security of confidential taxpayer data is critical to the ongoing mission of the CDTFA. A breach of confidential taxpayer data may lead to CDTFA's inability to effectively administer California taxes and fees.

A malicious attack on, or careless mishandling of, CDTFA systems could result in impacts to the confidentiality, integrity or availability of CDTFA data, services and or processes.

This could result in the loss of California revenue and damage to taxpayer confidence.

CONTROL A

Implementation of the Information Security Program Transformation & Governance Road Map initiative, as defined by an independent risk assessment, will enable the Information Security Office to become the critical component in supporting an increasing demand for protecting against cybersecurity threats reducing the impact and likelihood of a data breach. The Security Program Transformation Roadmap initiative includes the following activities:

- *Refreshing the Information Security Policy Program*
- *Information Security Program Transformation*
- *Information Security Governance*
- *Information Security Risk Management*

RISK: OPERATIONS -INTERNAL-TECHNOLOGY—SUPPORT, TOOLS, DESIGN, OR MAINTENANCE

Legacy systems require extensive maintenance, and it is increasingly difficult to recruit and retain staff with the knowledge and experience with these systems. Until the full implementation of the Centralized Revenue Opportunity System (CROS) System, internal users and taxpayers may need to complete their tasks by using both the new functionality of CROS and existing systems.

This is due to the obsolescence of the technology that supports CDTFA's critical business.

A lack of qualified staff to maintain these mission-critical systems may result in increased system failures, inadequate reporting capabilities, and delays to implement legislative mandates. This may result in a delay of the ability of CDTFA users to maintain service levels and for taxpayers to complete their commitments in a timely manner. In addition, if CDTFA is unable to perform its mandated tasks in a timely manner, CDTFA's ability to meet the state's revenue goals may be impacted.

CONTROL A

Maintain department resource levels of technical skills and knowledge of CDTFA's legacy systems, the Integrated Revenue Information System (IRIS) and the Automated Compliance Management System (ACMS), databases, and architecture by performing cross training of existing staff, using retired annuitants, and when necessary, using consultants. Having adequate numbers of trained staff will ensure that existing systems can maintain their current levels of service until the full system implementation of CROS.

CONTROL B

Minimizing changes to the legacy systems by prioritizing enhancement items and freezing non-critical enhancements.

RISK: OPERATIONS -INTERNAL-NEW SYSTEM IMPLEMENTATION (OTHER THAN FI\$CAL)

Until the CROS solution is fully implemented, some CDTFA staff and tax and fee payers may need to perform work in both the CROS and legacy system environments.

The phased approach for CROS implements the tax and fee programs administered by CDTFA over three rollouts.

The phased implementation approach may result in a loss of productivity, inefficiencies for the users and increased operational costs.

Some tax and fee payers may need to conduct business with the CDTFA using both the CROS solution and legacy systems if they have multiple tax program responsibilities. This may result in confusion by tax and fee payers when interacting with the department.

CONTROL A

Communicating organizational and business procedure changes to impacted tax and fee payers and staff for programs included in Rollout 2. This will clarify to tax and fee payers and staff which of their activities will need to be performed using the CROS solution and which need to continue to be performed in legacy systems.

CONTROL B

Minimize the number of impacted tax and fee programs in each rollout. This will significantly minimize the number of tax and fee payers who will need to use both CROS and legacy systems to perform their work.

CONTROL C

Provide job-specific training and support for CDTFA users on how to perform tasks that relate to their specific business areas. This will give CDTFA users clear direction on the tasks that they need to perform in the CROS solution and those that they will continue to perform using legacy systems.

RISK: OPERATIONS -INTERNAL-OVERSIGHT, MONITORING, INTERNAL CONTROL SYSTEMS

Recent audits by control agencies of the CDTFA identified an overarching risk that could result in the inability of the CDTFA to meet its fiduciary responsibilities of accurately and effectively managing state resources.

This is due to a lack of internal controls, oversight and monitoring.

This could result in the theft, loss, misuse or misappropriation of state resources that could adversely affect the fiscal resources relied upon by Californians to fund vital services and infrastructure. In addition, to the loss of faith and trust Californians have in CDTFA's ability to carry out its established roles and responsibilities.

CONTROL A

Ensure policies and procedures are current and maintained in accordance with statutory provisions. Keeping policies and procedures current and up-to-date reduces risk by providing accountable persons with the tools needed to accurately and effectively perform their roles and responsibilities in compliance with current statutory provisions.

CONTROL B

Implement business practices and a system of internal controls to accurately and effectively manage resources. Focusing on best business practices and strong internal controls reduces risk by creating an organizational culture and related structure that sets standards to ensure proper segregation of duties, reconciliations, reviews and approvals, along with reporting and monitoring responsibilities. These types of controls, by design, significantly limits the ability for theft, loss, misuse and misappropriation and encourages a work environment focused on constant improvement.

CONTROL C

Use business metrics, data analytics, Key Performance Indicators (KPIs) and dashboards to prove and improve business operations. This information will assist management in identifying issues or areas of concern.

RISK: OPERATIONS -INTERNAL-STAFF—KEY PERSON DEPENDENCE, WORKFORCE PLANNING

The CDTFA is a new state department, formed after passage of the Taxpayer Transparency and Fairness Act of 2017, which reorganized the BOE into three separate entities effective July 1, 2017. The tax appeal functions were transferred to the newly established Office of Tax Appeals, but most of the BOE's responsibilities for administering tax and fee programs were transferred to the newly established CDTFA, which reports to the California Government Operations Agency.

The CDTFA was created after intense legislative and media scrutiny that highlighted a number of workforce challenges and risks. Some of the most visible workforce challenges involved allegations of a lack of a fair, and impartial, competitive selection process, and allegations of nepotism throughout the organization. As a result, CDTFA is in process of implementing a new anti-nepotism policy and an improved hiring process with added controls.

As new leadership assesses the organization and defines and creates a new strategic plan and business model, we anticipate that the organization structure may need to change to accomplish and meet the challenges ahead. By harnessing new technology, streamlining our processes, and ensuring that we are adapting to the changing economy in California, our business model and associated organization structure will change to better serve our stakeholders.

CONTROL A

Control A

Establish a robust workforce plan that includes:

- A data-driven assessment of staffing allocations and organizational structure in light of expected future business needs and CDTFA's strategic plan
- Implementation, education and ongoing adherence to the anti-nepotism policy
- Implementation, education and ongoing adherence to the CDTFA Hiring and selection policy and process
- Recruitment initiatives to attract top talent and brand CDTFA as an employer of choice
- Retention initiatives that include:
 - Creating an environment that focuses on continuous learning aligned with CDTFA's strategic plan;
 - Robust succession planning and mentoring program; and
 - Knowledge transfer activities to ensure mitigation of key person dependence.

CONCLUSION

The California Department of Tax and Fee Administration strives to reduce the risks inherent in our work and accepts the responsibility to continuously improve by addressing newly recognized risks and revising controls to prevent those risks from happening. I certify our internal control and monitoring systems are adequate to identify and address current and potential risks facing the organization.

Nicolas Maduros, Director

CC: California Legislature [Senate (2), Assembly (1)]
California State Auditor
California State Library
California State Controller
Director of California Department of Finance
Secretary of California Government Operations Agency